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Global Tax Alert

Hong Kong Tax Authority issues practice note on deductibility of R&D expenditures

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Executive summary

The Hong Kong Inland Revenue Department (HKIRD) issued a practice note (PN) in April 2019, providing a detailed explanation and guidance on the normal or additional tax deductions for research and development (R&D) expenditures under the recently enacted law (the New Law)[1].

Detailed discussion

Overview

Under the New Law, effective for expenditures incurred on or after 1 April 2018, qualifying R&D expenditures on a qualifying R&D activity (wholly undertaken and carried on within Hong Kong) will be eligible for a 300% deduction for the first HK$2 million (USD250k), and the remainder, a 200% deduction without limitation. Nonqualifying R&D expenditures will continue to be eligible for the normal 100% deduction.

With respect to subcontracted-out qualifying R&D activities, the payments must be made to a "designated local research institution" to qualify for the additional deductions.

For in-house qualifying R&D activities, expenditures that qualify for the additional deductions are: (i) in relation to an employee who is engaged directly and actively in the activities; or (ii) on a consumable item that is used directly in the activities.

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PN explanation and guidance

1) **Qualifying R&D activity must be for making an advance in science or technology**

   The definition of a "qualifying R&D activity" looks at whether an R&D project aims at making an advance in the overall knowledge or capability in a field of science or technology that is generally readily and publicly available.

2) **Partial undertaking of R&D project in Hong Kong**

   Even if some of the R&D project activities are carried on outside Hong Kong, additional tax deductions may still be claimed as R&D expenditure to the extent they are incurred on those activities carried on in Hong Kong, provided that they fall within the definition of a "qualifying R&D activity."

3) **Costs shared under a cost contribution agreement (CCA)**

   When a Hong Kong group enterprise has undertaken part or all of the underlying pooled R&D activities of the group under a CCA, the costs shared by the Hong Kong enterprise under the CCA may be accepted as in-house R&D expenditure incurred by the enterprise if the following conditions are satisfied by the Hong Kong enterprise:

   i. Possess the capacity, knowledge and expertise to control the development, enhancement, maintenance, protection and exploitation functions
   ii. Co-own any rights generated from the R&D activities with other CCA participants
   iii. Share costs by the respective CCA participants

   Making a buy-in payment and receiving a buy-out payment would result in a nondeductible cost and taxable income, respectively.

4) **Nominee's holding of rights**

   The New Law denies a deduction for R&D expenditures incurred by an enterprise if any rights generated from an R&D activity are not, or will not be, fully vested in the enterprise. However, the PN states that if rights are held by an special purpose vehicle (SPV) company only as a nominee for the enterprise performing an R&D activity, the enterprise is treated as an economic owner of the rights; consequently, the enterprise would be able to claim the normal or additional tax deductions for the R&D expenditures incurred.

5) **SPV can claim tax deduction by undertaking R&D activities**

   The New Law denies a deduction for R&D expenditures if an R&D activity is undertaken by a person on behalf of another person. However, under the PN, an SPV may still be treated as an economic owner of the rights if the SPV undertakes R&D activities and charges royalties to other group companies for the use of the rights so generated; accordingly, the SPV would be able to claim the normal or additional tax deductions for R&D expenditures.

6) **Extra-statutory concession on relatively insignificant subcontracting fees paid**

   If the subcontracting fees paid to an overseas associate for R&D services are not more than 20% of the total costs of the R&D project, and the subcontracting fees in aggregate are not more than HK$2 million, the subcontracting fees would be regarded as an in-house expenditure eligible for the normal tax deduction, irrespective of the general nondeductible treatment under the New Law.

7) **Qualifying expenditures eligible for the additional tax deductions**

   a. *Costs of employees directly or actively engaged in qualifying R&D*

   Under the PN, the following individuals would generally be treated as employees of the enterprise if the employer and employee relationship exists:

   - Secondees or expatriates sponsored by the enterprise
   - Expert consultants under a temporary employment contract with the enterprise, and
   - Part-time R&D staff

   In addition to salary, wages and retirement benefits, employee costs eligible for the additional tax deductions include any other benefit that constitutes cash paid by the employer, other than stock-based compensation such as share options and share awards.

   b. *Consumable items directly used in a qualifying R&D activity*

   Examples of consumable items include: (i) a laboratory chemical which is used up or converted into an unusable product in an R&D process; and (ii) an electronic component that is integrated into a prototype and is no longer available for use for another purpose.

Endnote

1. See EY Global Tax Alert, *Hong Kong passes new legislation to grant increased tax deductions for qualifying R&D activities*, dated 26 October 2018.

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